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Consumer Loans

1. Overview of Target Assets

Consumer loans (loan receivables of consumer finance companies) are typically small-scale and diversified receivables, making it most desirable for securitization. In most cases, it takes the form of a revolving credit that allows borrowing and repayment within a credit line at any time, and the securitization scheme is built according to such characteristics.

The concept of rating consumer loan securitization is also applicable to the rating of securitized products of cash advance on credit cards held by bank-affiliated and distributor-affiliated credit card companies and credit sales companies.

2. General Scheme

From the perspective of legal risk, consumer loans held for customers is generally entrusted to a trust bank and are classified into senior, subordinated or seller beneficial interest. In some cases, the senior beneficial interest is in turn transferred to a special purpose company (SPC), which subsequently issues bonds backed by the senior beneficial interest.

The subordinated beneficial interest and seller beneficial interest are held by the originator. The seller beneficial interest aims to absorb fluctuations in the balance of consumer loans transferred to the trust bank and does not function as a credit enhancement.

The originator provides collection services for the underlying assets as a servicer and delivers the collected funds to the trust bank. The trust bank or SPC uses the funds provided by the servicer to pay the principal and interest on the senior beneficial interest or bonds.

The pool of transferred receivables is reduced by the ordinary repayment of principal. During the revolving period, the originator is required to add new consumer loans and maintain the balance of the loan receivables at a certain level.

If an early redemption event occurs, the aforementioned additional transfer of the loan receivables is ceased and any new transfer from the originator is suspended. The collected interest from the underlying obligor is used for the redemption of principal for the senior beneficial interest, accelerating the redemption of the securitization products.

3. Key Analytical Points

Analysis of securitization of consumer loans focuses on credit risk assessment, which relates to the level of credit enhancement, and legal risk assessment, which examines how its structure coordinates with the regulations of the Money Lending Business Act.

(1) Risk of deteriorated creditworthiness of underlying debtors

Subordinated beneficial interest absorbs the amount of losses resulting from bad debts of the underlying obligor. Total loan losses assumed during the securitization period is calculated on the basis of law of large numbers approach using historical data.

Changes in indicators derived from historical data such as the default rate, additional borrowing rate and principal repayment rate are examined to arrive at a base to be adopted in an analysis. Usually, each parameter is adjusted to the level closer to the performance of the receivables to be transferred. This is done by using the mean of the historical data as the basis as well as assessing the trends from the past and anomalies and through an interview with the originator.

Certain stress scenarios are applied to indicators such as the default rate, additional borrowing rate and principal repayment rate to determine the subordination level needed for the rating. Because loan losses during the securitization period will be absorbed by the subordinated tranche and excess spread, the level of necessary credit enhancement (subordination ratio) will vary depending on the level of the interest rate on the loan expected during the securitization period.

Standard Stress Multiplying Factors:

Rating	Stress Multiplying Factor
AAA	3.5 times
AA	3.0 times
A	2.5 times
BBB	2.0 times

(2) Commingling risk

As a credit enhancement for commingling loss that occurs when funds become uncollectible upon an originator's bankruptcy because funds are mixed with those of the originator, JCR sets an amount that is minimally required for the seller beneficial interest to be kept according to the remittance schedule of collected funds for the securitized product to be rated.

(3) Deterioration in quality of transferred receivables during the revolving period

Securitization of consumer loans involves the risk of an increase in obligors with a large number of lender exchanges (LE or borrowing from other finance companies) due to additional assignment during the revolving period and the risk of an increase in LE of the same obligor as time passes (discovered during the examination for additional lending by the originator). As measures against such risks, dynamic reserves are arranged according to the number of LE and the delinquency rate. This has the same effect as setting up a loan loss reserve that matches the credit risk level.

In addition, general practice is such that an additional assignment of loan receivables is suspended and an early redemption of the senior beneficial interest or bonds is commenced if the default rate or delinquency rate of the assigned claims exceeds a certain level, or if the principal repayment rate has declined.

(4) Legal risk

Consumer loans are subject to various regulations to protect consumers as described below, which require an adequate examination of securitized products.

A. Obligation of notice under the Money Lending Business Act

Article 24, Paragraph 2 of the Money Lending Business Act requires that, when loan receivables have been assigned, an assignee notify the obligor of the fact of the assignment by delivering the document prescribed in Article 17 ("Article 24-2 notice"). However, the method of sending the notification to the obligor may violate the privacy of the obligor. Accordingly, it is general that as long as the originator, the assignor, provides collection services and keeps in contact with the obligor, it withholds notification, but that when servicer replacement occurs, the trust bank delivers the Article 24-2 notice as well as the assignment notice to the obligor.

B. Gray zone interest rate

In the case that, in the pool of the loan receivables to be securitized, there exist loans to the obligors who in the past have paid interest that exceeds the maximum interest rate in the Interest Rate Restriction Act (18% per year for principal of 100,000 yen or more and less than a million yen), the trust bank could incur a new obligation to repay the excess interest, which may jeopardize the scheduled cash flow.

In securitizing loans, therefore, it is desirable from the viewpoint of ensuring the certainty of the scheme to extract from the loans held by the originator only those held for the customers who have no history of borrowings at an interest rate above the aforementioned statutory rate. Furthermore, in the case of term loans without a principal loan contract, even when a past loan contract has given rise to the right to demand reimbursement for overpayments, its impact on securitization can be considered extremely low so far as the loans are based on new borrowings after a lapse of 10 years since previous ones were paid off.

Reference: "Items prescribed in Article 17 of the Money Lending Business Act"

- Revolving Credit Loan

  (a) Name and address of money lender, (b) contract date, (c) maximum amount, (d) interest rate, (e) repayment method, etc.

- Other than Revolving Credit Loan

  (a) Name and address of money lender, (b) contract date, (c) amount of loan, (d) interest rate, (e) repayment method, (f) repayment period and number of repayment installments, etc.

4. Monitoring

In principle, JCR monitors the performance of underlying assets and reviews the rating as long as a rated debt is outstanding. JCR conducts monitoring on a constant basis to check the performance of underlying assets, including the monthly default rate; changes in the subordination ratio; and capabilities of parties to the structure to carry out their duties. When conducting the review of credit ratings, JCR reexamines, as necessary, the base rate and other rating assumptions in light of the performance of underlying assets and economic conditions and analyses cash flows based on these assumptions with due consideration given to the remaining term of securitization products. Rating review is held on a regular basis, as well as on an ad hoc basis as necessary in case of a sudden change or event.

5. Documents Required

(1) Documents concerning the originator

(2) Qualitative information on consumer loans

- A. Product overview
- B. Credit criteria / flow
- C. Bad debt disposal, recovery flow
- D. Claim for payment, accounting system and related information
- E. Loan agreement template, credit card agreement
- F. System and requirements for extracting claims to be assigned

(3) Quantitative data on consumer loans

- A. Historical data of the matrix claims
- B. Attribute data of the matrix claims and assigned claims
  - i. By age (in units of 10 years)
  - ii. By annual income (in units of 1 million yen)
  - iii. By occupation, by type of job
  - iv. By region (prefectures)
  - v. By the number of LE

6. Related General Criteria

"Commingling Risk Pertaining to Securitization Products"

"Backup Servicer in Securitization"

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